

Analysis of Washington State's Unemployment Insurance Trust Fund

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Why has the trust fund balance grown so rapidly?

Between the end of 2004 and the end of 2006 Washington's UI trust fund balance increased by about \$1.6 billion from roughly \$1.4 billion to roughly \$3.0 billion.

Understanding why the increase was so rapid is important to legislators, to ESD and to all stakeholders in Washington.

The following paragraphs discuss this increase and try to place broad parameters on the question: How much is a surprise? Following recessions, unemployment and claims decrease as the economy recovers. Also, the normal operation of experience rating causes the average employer tax rate to increase. Thus in any recovery, the trust fund increases because benefit payouts decrease and employer taxes increase. The third important trust fund flow is interest earnings. As the fund balance recovers, interest earnings increase since they are mainly determined by the trust fund's average balance.

In Washington State several other factors have been operative during 2005 and 2006 and will continue to be operative in the future. On the benefit side, the following restrictions are now "permanent" compared to benefit provisions prior to 2004. 1) The maximum benefit is now 63 percent (not 70 percent) of lagged average wages. 2) The statutory replacement rate is now 50 percent (not 52 percent). 3) Maximum potential benefit duration is now 26 weeks (not 30 weeks). 4) There are now more disqualifying voluntary quits and MLFA has been totally abolished. The associated noncharges have declined sharply. 5) Tax rates are now mainly determined by lagged four benefit ratios of each individual employer. 6) An explicit noncharged benefits tax is operative with a minimum rate of 0.5 percent.

If we had a perfect understanding of how statutes affect behavior and influence benefits and taxes, we could with confidence estimate the contribution of each of these six factors to the trust fund recovery along with the contribution of higher interest earnings attributable to the increased trust fund balance.

In the time available to prepare this report, I have not been able to make estimates of the effects each of the seven factors, but I can make a number of observations.

1. On the benefit side, the **reciency rate** (the ratio of weekly beneficiaries to weekly unemployment) averaged about 0.26 in 2005 and 2006. This ratio was lower than in earlier recoveries by some 0.03 to 0.06. Assuming that roughly 0.04 is due to policy changes (increased disqualifications and shorter potential benefit duration) this would imply about 7,000 fewer beneficiaries per week and an associated benefit reduction of some \$200-\$225 million for the two years.¹

¹ The basic orders of magnitude are roughly 170,000 unemployed times 0.04 yielding about 7,000 fewer beneficiaries per week. This implies about 350,000 fewer weeks compensated in 2005 and 2006. With a WBA of \$310 the two year savings in benefits of \$219 million.

2. A second change in benefits has been a reduction in the **replacement rate** (the ratio of weekly benefits to weekly wages) of say 0.02 due to the lower statutory replacement rate and the lower maximum weekly benefit. This would represent a reduction in benefit payments of about \$80-\$100 million for the two years.²
3. Because of lags involved in use of four year benefit ratios to set taxes, **the noncharged benefits tax** in 2005 and 2006 was recouping ineffectively assigned benefit charges from earlier years of high benefit claims. Rough estimates of tax receipts in 2005 and 2006 from the noncharged benefits tax with rates of 1.08 percent and 0.67 percent respectively are about \$550 million in 2005 and \$360 million in 2006 for a total of more than \$900 million. Actual ineffectively assigned benefit charges during these two years were less than \$200 million in each year.³ Thus comparing only the annual yield with actual ineffective charges suggests the two year tax yield was at least \$500 million higher than these ineffective charges. This disparity arises partly because the tax looks back to four years which were years of high benefit payouts and high ineffective charges. For future years there seems to be a continuing problem because the minimum rate for this tax of 0.5 percent will raise about \$300 million per year while ineffectively assigned charges seem likely to average less than \$200 million per year.
4. It also seems likely that the operation of **the new experience rating system** has caused experience rated tax rates to respond more under the new tax statute than under the predecessor statute. Estimating the amount of added tax receipts from this changeover was not attempted here, but the direction of the change seems clear to me. The new system is more responsive than the previous four-year benefit ratio system with array allocation that it replaced.
5. **Interest income** is higher because the fund balance has been increasing. An estimate would be \$80 million of added interest income for the two years and perhaps \$40 million due to policy changes that reduced benefits and increased taxes.⁴

Summing across the four factors with their rough estimates, the total is about an \$800-850 million change in tax, benefit and interest flows to raise the end-of-2006 trust fund balance above what it otherwise would have achieved. Increased taxes, increased interest and reduced benefits all have contributed in a significant way to this outcome. Policy actions seem to have accounted for at least half of the \$1.6 billion increase in the trust fund balance for the two years.

² For the two years weeks compensated totaled about 5.0 million and a reduction in the replacement rate of 0.02 would represent about \$16 per week (with a weekly wage of \$820 per week). The product is about \$80 million for the two years.

³ This inference is based on ineffectively assigned benefit charges for the fiscal years 2005 and 2006 and recognizing that calendar year data roughly reflect averages of fiscal year data for the current and next year.

⁴ I am assuming a yield of 5.0 percent on trust fund balances. At the end of 2005 the balance was nearly \$900 million higher than at the end of 2004 and an additional \$700 million higher at the end of 2006. If half of the accumulation was due to policy actions affecting benefits and taxes, this would represent a higher average balance of \$225 million in 2005 and \$625 million in 2006 and associated higher interest of about \$11 million in 2005, \$31 million in 2006 or more than \$40 million for the two years.

Two final observations may be appropriate.

- First, the noncharged benefits tax clearly has a floor that is too high. In light of the volume of ineffectively assigned benefit charges of 2005 and 2006, a minimum rate in the 0.2-0.3 percent range should be considered.
- Second, understanding how the experience rated tax rates will respond to changes in the trust fund balance and to benefit charges remains a critical challenge for the ESD actuarial model.

Ineffectively Assigned Benefit Charges

Ineffectively assigned charges fall into three categories: 1) charges against inactive accounts, 2) ineffective charges (the excess of benefit charges above taxes for employers at the maximum tax rate) and 3) noncharged benefits. The latter include several categories of charges where the employer is relieved of charges either because the employer had no responsibility for the separation or because benefit eligibility was deemed appropriate but the employer was relieved of the associated charges.

Ineffectively assigned charges account for a substantial share of all benefit payments. In the past, their share of total benefits has been as high as half. During fiscal years 2005 and 2006, however, their share dropped to roughly 20 percent. Much of the decline was caused by legislation enacted in 2003.

Table 1 presents summary detail on these charges by category in fiscal year data that extend back to 1990. Readers are reminded that fiscal year 2005 represents a transition year for taxes since July-December 2004 tax rates were set under the earlier system with array allocation while January-June 2005 had rates set under the current system which relies mainly on individual employer experience in determining tax rates.

The ERI series in column [8] indicates that experience rating was already increasing in 2004 and 2005. The explanation is largely that ineffective charges (column [2]) are the most cyclically sensitive of all the various ineffectively assigned benefit charges. A higher percentage of charges fall into this category during recessions hence the high percentages in 1994-1996 as well as 2002-2003. Inactive account charges are comparatively stable as all entries in column [1] are in the range from 6.9 percent to 12.8 percent. Note that this percentage decreased in 2006.

Traditionally, noncharged benefits have been the largest category of ineffectively assigned benefit charges in Washington. Between 1990 and 2003, the noncharged percentage averaged 18.4 percent compared to averages for the same years of 10.3 percent for inactive account charges and 11.3 percent for ineffective charges. Note in column [3] how the noncharged percentage has been systematically lower in the most recent years.

Much of the reduction in noncharged benefits can be linked to legislation of 2003 that ended the MLFA noncharged and restricted the range of allowable voluntary quits. The MLFA percentage has gone to zero and the voluntary quit percentage averaged about 3.0 percentage points lower during 2005-2006 than during 1990-2003.

The data in Table 1 show substantial variation for several categories during 2005 and 2006 compared to earlier years. ESD might want to review the basis for their estimates of these categories to ensure that no errors have been made in producing the most recent estimates. For example, does the increase in column [7] reflect a cyclical response, similar to the 1994-1995 increase, or is there another factor at work? The most unusual aspect of the 2006 data is the decrease to zero of ineffective charges. Even though some charges in 2006 appear as “All Other Noncharges” it seems questionable to this author that there would be zero ineffective charges for the fiscal year⁵.

The final observation about Table 1 is the increase in experience rating of recent years. The ERIs of 2005 and 2006 are by far the highest of all years since 1990 (and back to 1988, the earliest year of ERI data). Compared to past years, a much larger percentage of benefit charges are assigned back to individual employers. The 1990-2003 average of about 60 percent appears to have increased to close to 80 percent.

An important related point is that Washington can probably anticipate a lower volume of ineffectively assigned benefit charges in future years. If this is the case, it has obvious implications for the setting of the noncharged benefits tax rate. Under the current tax statute, the minimum is 0.5 percent of taxable wages. It seems the minimum should be lower if it is to roughly match the volume of ineffectively assigned benefit charges in periods when total ineffectively charged benefits are low. Otherwise it will add to the trust fund balance year after year. If the “excess” noncharged tax rate falls into the 0.2-0.3 percent range, that alone would add about \$125 million to the trust fund each year the “excess” is at such a low level and the minimum noncharged rate remains at 0.5 percent.

Table 1. Ineffectively Assigned Benefit Charges, 1990 to 2006

Fiscal Year	Inactive Account Charges [1]	Ineffective Charges [2]	Noncharged Benefits: = [4+5+6+7] [3]	MLFA [4]	Vol Quit [5]	Misconduct [6]	All Other Noncharges [7]	ERI=100-[1]-[2]-[3] [8]
1990	10.1	4.5	19.6	6.4	8.3	1.0	3.8	65.9
1991	10.1	8.7	19.6	6.1	9.0	1.1	3.3	61.6
1992	10.8	11.7	16.0	4.9	6.0	0.9	4.1	61.5
1993	12.1	13.1	15.7	4.7	6.5	1.0	3.5	59.1
1994	10.1	14.9	23.9	5.0	6.3	1.0	11.6	51.1
1995	6.9	11.4	26.4	5.2	6.9	1.2	13.1	55.3
1996	6.9	11.3	20.1	5.0	7.2	1.2	6.8	61.6
1997	11.2	7.7	18.9	5.6	7.6	1.3	4.3	62.2

⁵ ESD’s response to Dr. Vroman’s comment: Ineffective charges decreased to zero in 2006, while benefit charge relief (referred to here as *noncharged benefits*) increased by \$66 million. This is due to the shift to two-quarter averaging for benefit payments and four-quarter averaging for benefit charges.

1998	11.3	9.5	17.3	5.8	8.0	1.3	2.2	61.8
1999	10.8	9.3	15.4	4.7	7.4	1.1	2.1	64.5
2000	9.7	8.2	15.2	4.4	6.7	0.9	3.2	66.9
2001	11.1	12.0	17.3	4.4	7.6	0.9	4.4	59.5
2002	12.8	20.7	15.3	3.3	6.4	0.8	4.8	51.2
2003	10.7	15.6	17.2	3.2	4.8	0.8	8.4	56.5
2004	9.4	9.0	10.8	-0.1	4.5	0.6	5.7	70.7
2005	10.1	3.4	7.8	0.0	4.6	0.8	2.4	78.7
2006	8.4	0.0	16.2	0.0	4.5	0.5	11.2	75.4

Data from ESD. All entries are measured as a percent of total benefits for the indicated fiscal years. The ERI is measured as 100 less the sum of the percentages in columns [1], [2] and [3]. Higher ERIs indicate a greater degree of experience rating.